DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15428
San Diego, Calif. 92115

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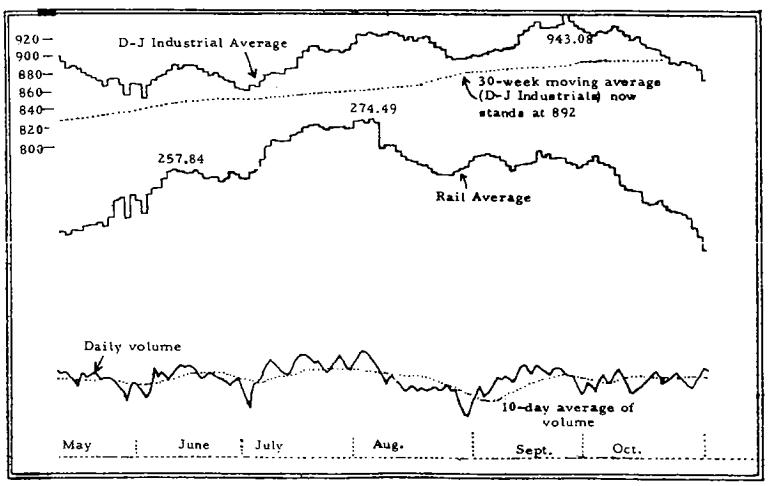
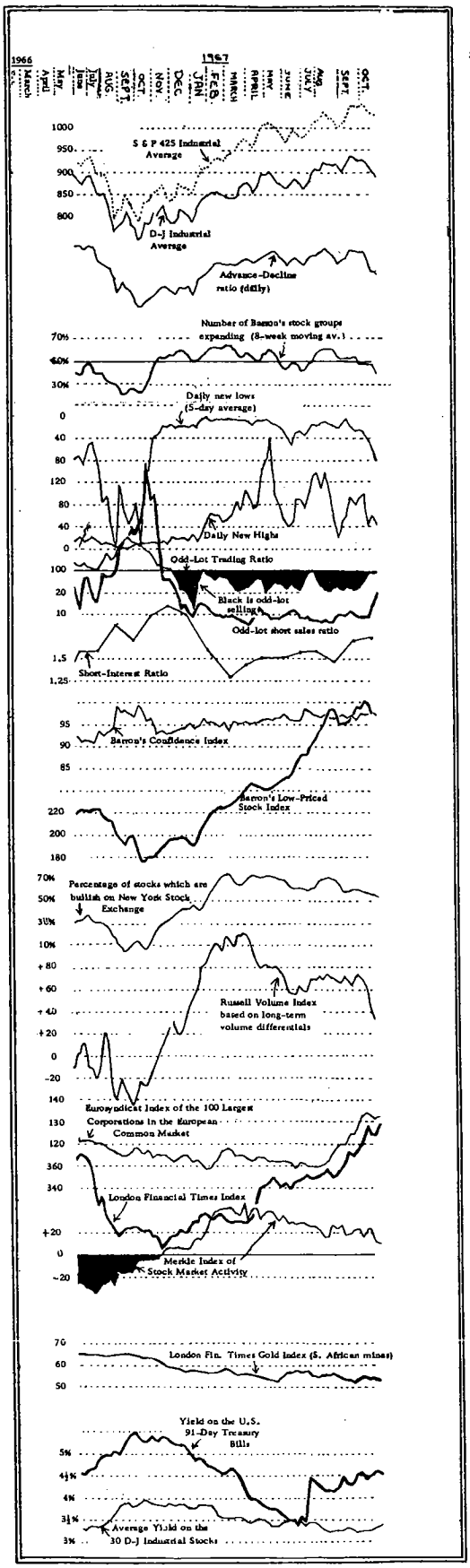
THE MARKET: When the Industrial and Rail Averages violated their August lows two weeks ago, many services rushed to announce "a Dow Theory bear signal." I do not subscribe to this thesis. I have never considered the rise since October, 1966, as a true primary bull movement. Therefore, the recent "topping out," as far as I can see, is nothing more than the belated exhaustion of a most extraordinary and explosive upward correction.

I believe that a primary bear market began on February 9, 1966 at 995.15 on the Industrial Average. The first major leg in the bear market took Industrials to 744.32 in October, 1966. A massive secondary, spurred by fantastically inflationary policies on the part of the Federal Reserve, advanced the Averages to highs recorded on August 4. Although the Industrials subsequently rose to a new recovery high on September 25, August 4 stands as the last confirmed high in the Averages. If the recovery has now topped out (as I believe it has), history will record the termination of the advance as August 4, the point at which the Averages posted their last confirmed highs.

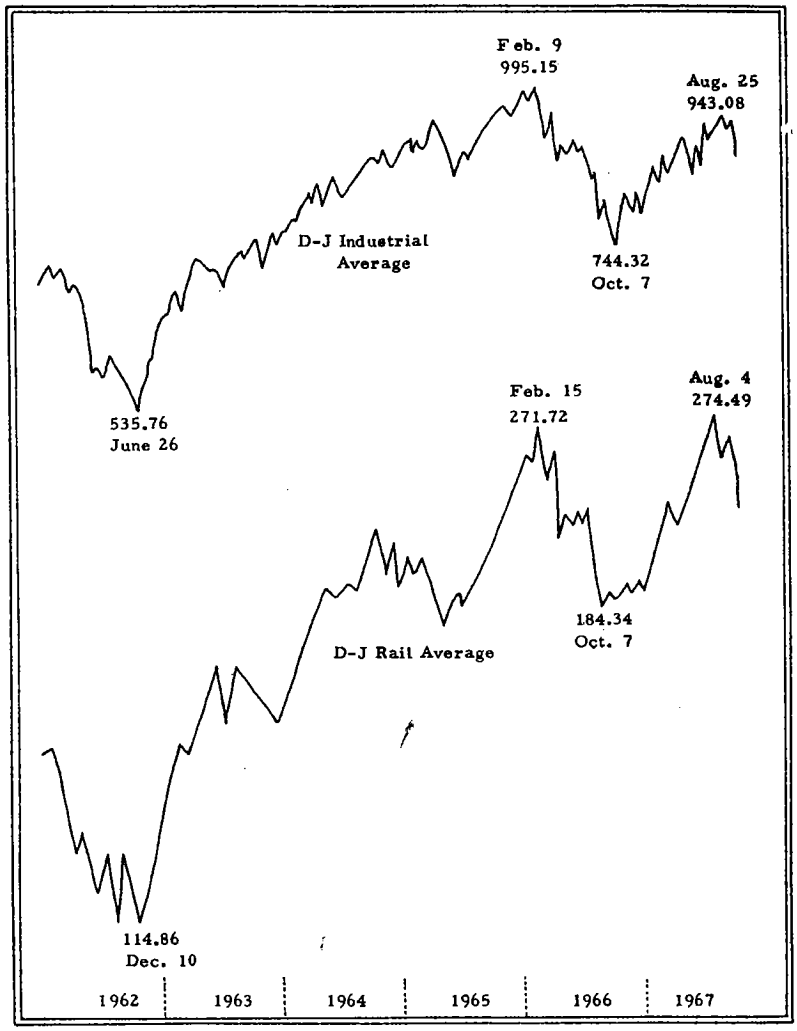
It is well to note that all during 1966 and 1967 the Rails (which have leveraged financial positions and are therefore more speculative than Industrials) have been outperforming the Industrial Average. But since August 4, the Rails have been definitely the poorer acting Average. As of this writing, Industrials have erased 28% of the gains since the October, 1966 lows. During the same period Rails have given up over 37% of their own 1966-67 gains. I take this to be a sign that the speculative ardor of the market is cooling off. In fact, so deep has been the Rail retracement that I doubt if any forthcoming rally will succeed in taking Rails to a new recovery high. Therefore, with Rails weak and "out of sight" on the downside, with Utilities and the 40-Bond Average at new lows for the year, but with Industrials holding up better than the other components, I would guess that the top was made in early August. Any forthcoming rally, in my opinion, would have the technical weight of a sloppy Rail, Utility and Bond sector as decidedly negative influences.

I notice that the great majority of investment services are now opining that the market is "oversold and ready to rally." This may well be true, but if my thesis is correct and this is the topping out of the 1966-67 secondary advance, it is extremely dangerous to try to predict when the bear market is ready to advance. Bear markets are meant to "clean out" the speculators,




1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

to eliminate the water from Wall Street, and they can be terribly deceptive and costly. Right now the Federal Reserve is worried about speculation in the market and they have moved to place restriction on convertible bond margining. The latest N.Y.S.E. figures show $5.7 billions borrowed to support stocks at this time with 780,000 margin accounts in operation. This is a fabulous testament to current speculation, but before this bear market is over the great majority of this margin "water" will be mercilessly squeezed out of the Street.



The huge short interest is now being advanced as a bullish prop under the market, but big short interests are a normal characteristic of bear markets and I would not count too much on the short interest alone to hold up equities.

On October 30, amid unanimous opinions that the market was "oversold" (as indeed it did appear), all four Averages, Industrials, Rails, Utilities and Bonds sank to new lows for the decline which began September 25. It is not a good sign when all components agree so unanimously, even though the market indeed appears overdue for an upward correction.

On October 31 amid increased selling pressure the Industrial Average cracked the 880 level while Rails broke sharply, the carrier's nineteenth decline in twenty trading sessions. On the same day, amid news that the new Government 5 5/8% 15-month notes and the 5 3/7 seven-year notes were received badly, all segments of the Government bonds market sank to record lows. There is no question in my mind but that the almost chaotic conditions in the bond markets are now affecting the thinking of even the speculators in common stocks.

CONCLUSION: All three trends, primary, secondary and minor, are now bearish. It should be a dangerous windup for 1967. Millions and millions of shares are now "locked in" at higher prices corresponding to the "above 900 level" on the Dow.

THE BIG PICTURE: I have drawn a chart showing all declines or advances in the D-J Industrial and Rail Averages of 5% or more, covering the period since 1962. The chart is drawn to semi-logarithmic scale so that it shows percentages of advance or decline.

It is immediately apparent that the Rails have been the big movers since 1962, having shown a much larger percentage of advance than Industrials. Furthermore, Rail strength has been more persistent. Note for instance, that the 1966 bear market decline took Industrials far below their 1965 low whereas the Rail low of 1966 was above the 1965 low. Aside from the fact that the Rails have advanced a far greater percentage from 1962 to 1966 than Industrials, the holding of the 1965 lows (during the 1966 decline) was a second important hint as to superior Rail strength.

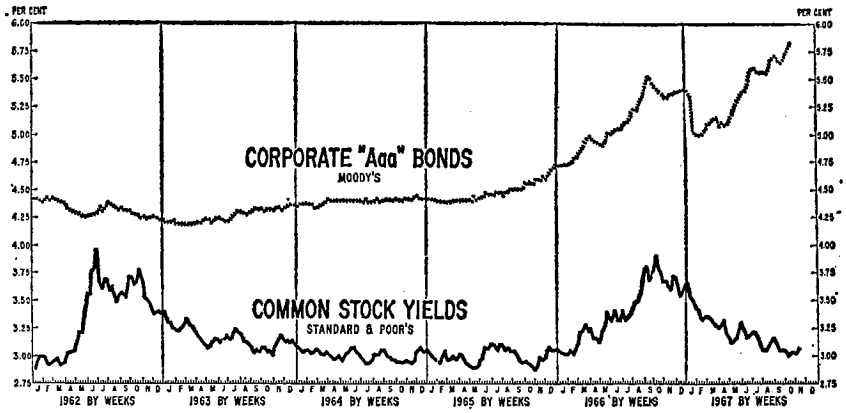
During the great rally from the October, 1966 bear market lows, the Rails pushed into all-time high territory. On August 4, 1967, Rails recorded an historic high of 274.49. Industrials failed by a fairly wide margin to hurdle their own February 8, 1966 bull market high of 995.15. Again Rail strength proved superior.

As far as Dow's Theory is concerned, the inability of Industrials to better the 1966 high constitutes a major non-confirmation. The last confirmed highs for the Averages occurred on August 4, 1967. From that point, although Industrials rallied for a few more weeks, the secondary trend turned bearish. As of this writing, Industrials have broken below the 890 level while Rails have backed off below 240.

Most people do not realize that despite a steady barrage of "inflation" and "higher earnings" propaganda, the Industrial Average is now below the peaks established in the years 1964, 1965, 1966 and 1967. Rails are below their 1965 and 1967 highs, but are still holding up better than Industrials.

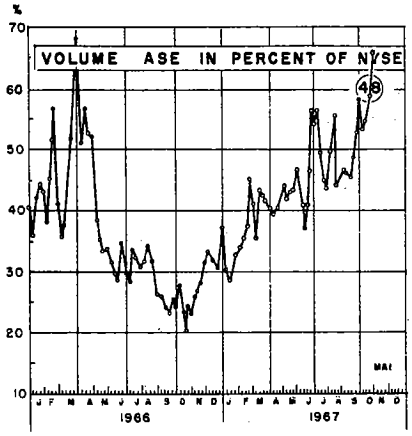
As far as my chart is concerned, the rise since 1966 does not appear to be any more than a bear market correction with Rails going to new bull market highs and Industrials refusing to confirm. The entire area since 1965 looks like a giant distribution zone with Industrials now below all major peaks recorded since late-1964 (it is of interest that the 1964 Industrial high was recorded on November 4 at 891.85). This three-year area appears to be one of distribution with Industrials getting substantially nowhere since the 1964 peak.

If my "rally in a primary bear market" thesis is correct, then it follows that prior to new highs (above the 1966 highs) in both Averages, the two indicators will turn down and ultimately smash below the 1966 lows, thus reconfirming the existence of a primary bear market.



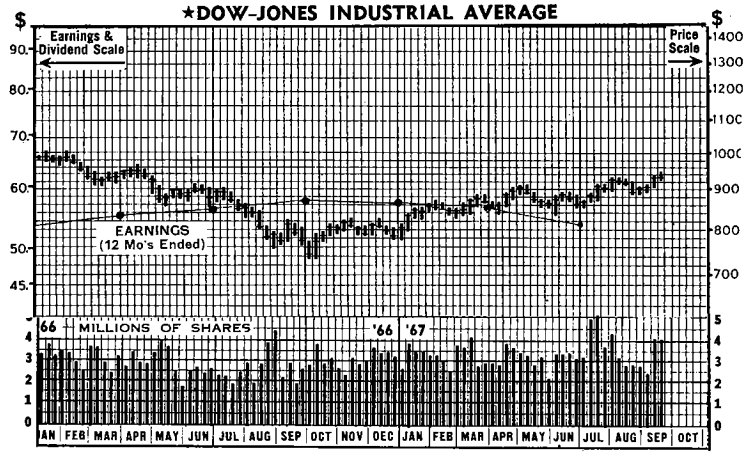
INCIDENTAL INTELLIGENCE: Last week the average yield on the S & P 500 Stock Average was 3.08%, the yield on Moody's Aaa rated bonds 5.84%, this brings the negative yield spread in favor of bonds to 2.76%, highest in history. This once-in-a-lifetime financial frea is shown on the accompanying chart.

I believe that bonds should now be viewed as entering a major buying area from a timing standpoint. In other words, I would not attempt to call the bottom of the bond decline on the basis of price, but I would bet that the bottom is struck within the next year from a time standpoint. Therefore, those interested in today's fabulous bond yields might place half of their money (that money which is earmarked for bonds) in the bond market at this time. My favorites would probably be some of the long-term U.S. Treasuries now yielding better than 5.4%. By not timing the price bottom, I mean that the ultimate lows might come in one month or eight months, but I am convinced that within a few years or so purchases executed in this area will look like bargains.



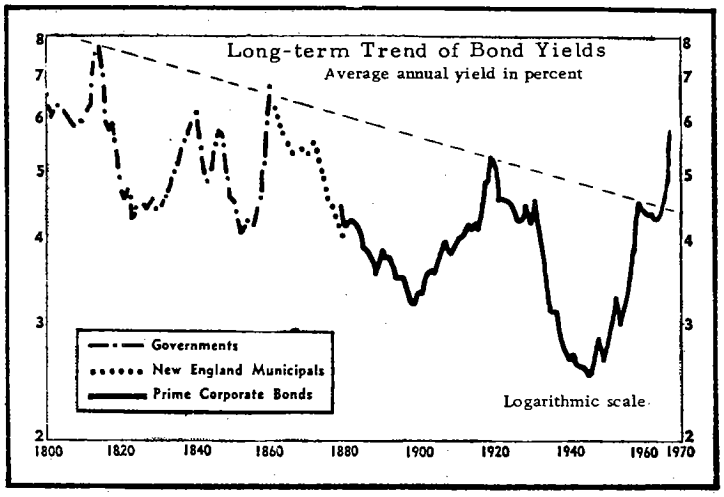
Price-earnings on the S & P Utility Average is now 14.4, lowest since 1957. Since World War II, the P/E on Utilities has tended to be higher than that of Industrials. The P/E on the S & P Industrial Average is now 18.3, which means that in terms of Industrials, Utility shares are now as cheap as they have been at any time during the last few decades. I would much rather purchase Utility shares here than Industrials, and it is obvious that their price has been driven down largely by rising interest rates.

Speaking of P/E ratios, the average P/E ratio for all shares on the Amex reached 18.9 in September. This more speculative exchange is doing a sort of speculative "freak out" of its own. On October 26 volume on the Amex touched 8.3 million shares against 9.9 million shares on the same day at the N.Y.S.E. This was the biggest day in the 118 year history of the Amex, it is indicative of the most intense and frenzied speculation. I include a chart (courtesy of Merrill Analysis) showing the ratio of Amex and N.Y.S.E. volume. Last week's figures took this "speculation index" roughly to the high point established in 1966, at which time the market was coming apart at the seams. It is obvious that speculation has again reached heights that can only be described as absurd.



My friends at Indicator Digest now guess (and they have been good in the past) that earnings on the Dow Industrials will be about $50 for the full year 1967. I include a chart from Securities Research showing annual earnings on the Dow through June. Note that the earnings line turned down in 1966, and if Indicator Digest is right (I happen to agree with them) this declining trend of annualized earnings should continue right through 1967. At $50 of earnings, the Dow at a price of 900 would be selling at 17 times earnings. This, in my opinion, is far too high under current conditions of social, monetary and political uncertainty.

BEAR MARKET IN BONDS: The accompanying chart shows the long-term bull and bear markets in bonds covering the last 170 years of American history. During that period we have had eight major swings, four bull markets and four bear markets. This chart shows the yield swings which, of course, run counter to the price movement. Thus, when the yields rise bonds are in a bear market.



Most bull and bear markets in bonds run far longer than primary movements in stock prices. Twenty years is about the average duration of a primary bond movement. But few people realize that the current bear market in bonds (rise in bond yields) is the greatest in both duration and extent in history. From the 1946 yield low of 2½%, Aaa corporate bonds have dropped in price until they now yield an amazing 5.7% on average. Thus, these prime bonds have better than doubled in yield over the 21 year period.

Note on the chart that the yield cycle has far exceeded the long declining trendline which has held for the past 140 years. This would appear to be an upside breakout in yields in the most dramatic and serious manner. Nothing like this in yields has been seen since the days of the Civil War. Everything about the yield formation on the chart suggests "climactic" action, a final yield surge such as was seen in the 1860's or the early 1920's.

When will the yield climb terminate? There is simply no way of telling, but from a timing standpoint I would guess within the next year. Therefore, large investment sources are undoubtedly accumulating prime bonds now, much as these same sources accumulated common stocks back in 1949 and 1950. Bonds are undoubtedly a great value now, based on all past history. In this writer's opinion, Aaa, Aa, and medium and long-term Treasury bonds may now be put in investment portfolios on a scale-buying plan. In a matter of a few years, today's bonds will look like bargains. All monetary crises have been temporary, as have all market peaks and all market bottoms. The times will change, and those who buy prime bonds in this area will reap the rewards of courage and patience.

GROUP STRENGTH: Group strength often provides strong hints as to the trend of the general market. I last reviewed group strength in Letter 363. At that time I showed charts of three group studies, and I am updating these charts in this issue.

The first group graph shows the weekly running total of groups advancing over groups declining. If during a week 24 groups advanced and 10 groups declined, a 14 would be added to the last total. Thus, we have a sort of group advance-decline line here, and it tends to be coincident rather than leading.

The second graph has true leading characteristics. It shows the number of Barron's groups advancing each week on an 8-week moving average basis. This indicator touched its high in mid-February at 65% advancing. It then sank to 40% in mid-June, rallied back to 61% in July. In September the indicator broke below the critical 50% level again, and it is currently at 42%. Thus from mid-February to the present, the groups advancing index has shown a profile of ebbing momentum. The less-than-50% of groups advancing over the past month is bearish.

The last graph (tabulations from the weekly Chartcraft) shows the number of the 89 Standard & Poor stock groups which are acting better than the broad market as represented by the S & P 500 Average. This indicator also has good leading characteristics. So far, it has closely followed the profile of the previous study, and the latest tabulation shows 51 groups now acting better than the S & P 500. When this index drops below 45, it means that less than half the S & P groups are acting better than the 500 Average, and such a situation would be bearish.